Stocks for the long run

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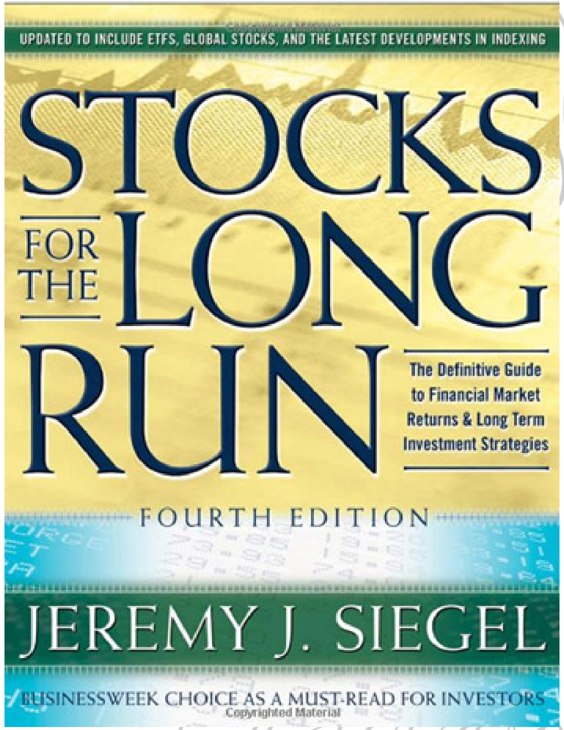
Executive Summaries

Wharton Business school professor Jeremy Siegel provides one of the most thorough analyses of long term investing. He concludes stocks should play a dominant role in your portfolio to preserve and grow your wealth.

Of particularly relevance to today's environment you might also note "the stock collapse of the 1930s caused a whole generation to shun equities and invest in government bonds and newly insured bank deposits, driving bond returns downwards". Subsequently newly bought stocks outperformed bonds by over 10% pa (the "equity risk premium") for several rolling 30 years periods, compared to an otherwise 150 year average premium of about 4% pa.

Today is also like the period prior to 1958 where the dividend yield from stocks exceeds the yield from bonds.



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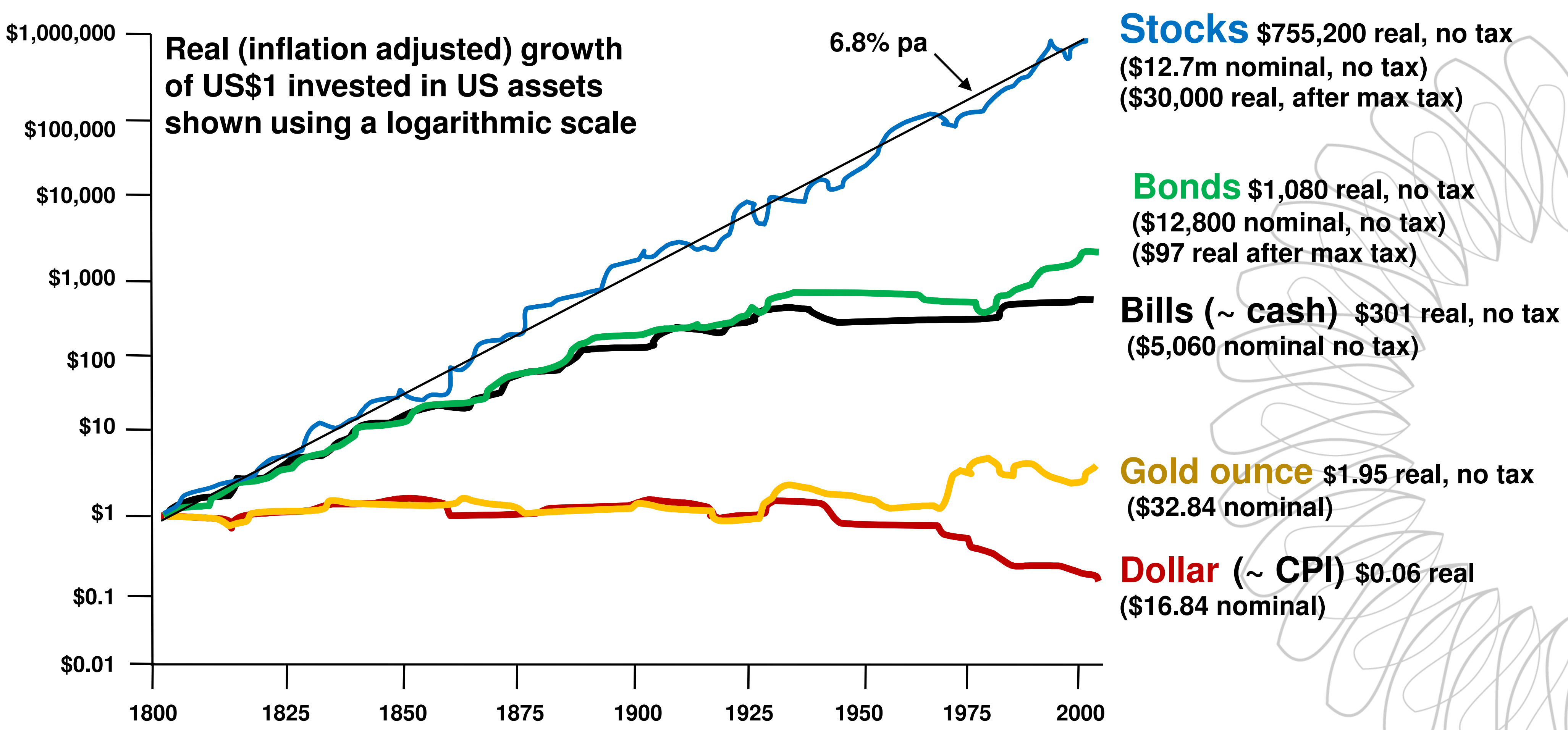
A <u>real</u> long view of returns - chart



Adapted from book's Figure 1-4 "Total real return indexes, 1802 through December 2006" and Figures 1-1 and 5-2
Visit below website to buy a copy of the original chart or buy this book
http://www.jeremysiegel.com/index.cfm/fuseaction/Resources.ViewResource/type/presentation/resourceID/6885.cfm
Growth includes reinvestment of dividends/interest and price appreciation

A real long view of returns - commentary (II of III)

The total return (appreciation + dividends) for US stocks from 1802 to 2006 is a relatively steady 6.8% above inflation

- **$1 invested grew to $755,163 in real terms (or in today's $'s 12.7m)**
- **"Mean reversion" of equity returns (ie. tendency for stock returns to correct after a prolonged period of high or low returns) enhances stability**
- **For period 1900-2006 the US ranked as fourth best global market (6.5% pa) after Sweden (7.9%), Australia (7.8%) and South Africa (7.5%). Country bond returns varied from 3% to -4% real, and all were less than stock returns**

Bonds (long-term government) and bills (short-term, cash-like investments) from 1802 to 2006 delivered lower real returns of 3.5% and 2.8% pa respectively

- **Bonds underperformed bills in the run up of 1970s inflation, then outperformed afterwards when they offered a higher, locked in yield**
- **"Mean aversion" of bonds implies under- or out-performance can persist**
- **After 1926, returns became less steady as interest rates fluctuated between nearly zero (during Great Depression and then held artificially low to fund WWII) to as high as 15% (during the inflationary 1970s). Previously they ranged mainly between 4 and 6% for 130 years**

A real long view of returns - commentary (III of III)

From 1800 to 1930 (over 130 years) consumer prices in both the US and UK did not change much, although some periods of modest deflation (1820s, 1870s) and inflation (1860s, 1920s) occurred

- **$1 purchasing ultimately eroded to a real value of 6 cents at the end of 2006**
- **The onset of this decline coincided with various countries abandoning the gold standard which previously restricted the supply of money and inflation**

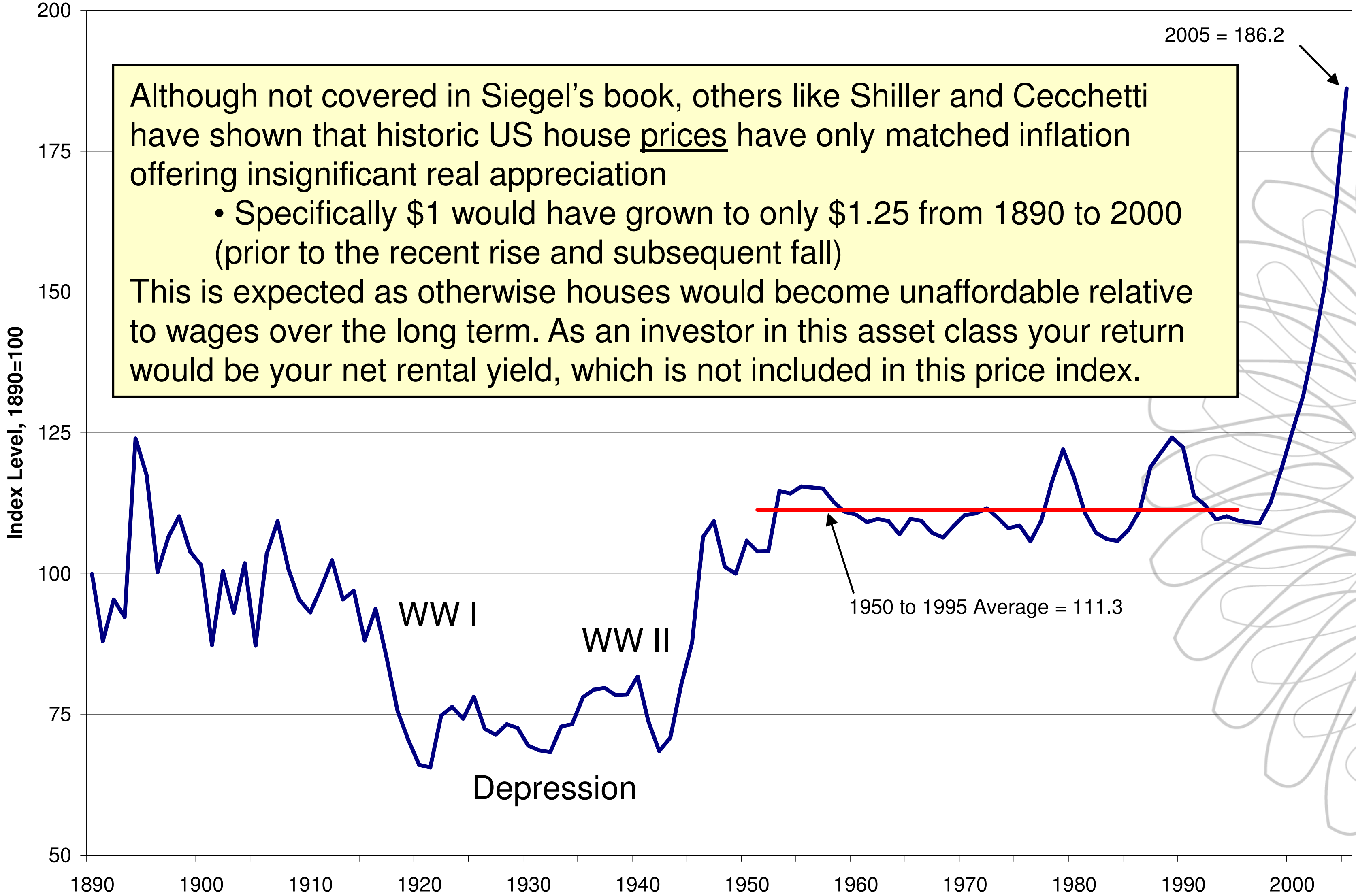
Price of gold followed overall trend of little inflation until about 1930. Afterwards and during periods of inflation like in the 1970s it provided useful price protection, however …

- **"Whatever hedging properties precious metals possess, holding these assets will exert a considerable drag on the return of a long-term investors portfolio"**

Tax puts a substantial drag on returns

- **"Since 1913 when US Federal income tax was instituted, the after-tax real return on stocks ranged from 6.3% pa for untaxed investors to 2.8% for investors in the highest bracket who don't defer their capital gains….**
- **… For taxable bonds, the real annual return changes from 1.9% (no tax) to -0.7% (highest tax rate) and for bills from 0.5 to -2.3% … taxes cause the greatest damage to fixed income investments"**

FYI, real US housing prices – 1890 to 2005



Source: Cecchetti (2005); http://econweb.rutgers.edu/bordo/HousingBoomBust_Oct05.doc.

On the safety of equities and bonds

“Stocks are unquestionably riskier than bonds or Treasury bills over one and two year periods … [however] It is very significant that stocks, in contrast to bonds or bills, have never delivered to investors a negative real [after inflation] return over periods of 17 years or more … although it may appear riskier to accumulate wealth in stocks rather than bonds over long periods of time, precisely the opposite is true: the safest long term investment for the preservation of purchasing power has clearly been a diversified portfolio of equities”

After holding stocks for 20 or more years, the standard deviation (variation) of returns from stocks was less than for bonds – and about ¾ of that for bonds/bills after 30 years

- **This is less than predicted if you assume stock returns are randomly distributed (due to “mean reversion” not “random walk” technically speaking)**

Bonds can still diversify a portfolio and lower overall risk despite lower returns

“For most long term investors, inflation-indexed bonds should dominate nominal bonds in a portfolio”

“Fixed income doesn’t mean fixed purchasing power”

Other historically based wisdom

"Rapidly expanding sectors often induce investors to pay too high a price, which results in lower returns. The best values are often found in stagnant or declining sectors ignored"

- Top performing S&P500 stock since 1957 has been Philip Morris (tobacco, consumer brands). In the US market, resource and materials companies have lagged the market over the last half century

"Small stocks exhibit periodic surges [eg. 1975-1983, 2000-2006] that have enabled them to outperform". Although 20% of total stock value is in small caps they aren't in the S&P500 size based index

"The reason to invest internationally is to diversify your portfolio and reduce risk" [not to necessarily enhance returns from faster growing economies]

Over the long term, equities are a good inflation hedge but "neither stocks nor bonds nor bills are good short term hedges against inflation ... No financial asset is"

"The bankruptcy of the steel manufacturers and airlines over the last decade are related to their inability to meet their pension obligations" [recently GM, Chrysler]

- "The corporate pension problem will disappear over time as the risk of funding retirement is shifted to individuals" [ie. now its your problem]

Advice for market timers? (calendar anomalies)

Generally ….

- **US stocks did better in the 1st half (esp. 1st 6 days) then 2nd half of the month**
- **Did well before holidays and poorly in September and better in January in the US and especially for small stocks this same month**
  - **September: approach of winter? selling to pay off American summer holiday?**
  - **January: follows US tax year-end selling of losers?**
    - **In Australia from 1970-2006, the September effect is an insignificant - 0.3% (vs -1%). We had a weaker +2% January effect (vs +3%)**
      - **perhaps instead we should expect a July effect aligned with our different tax year (not shown)?**
- **Tuesday is a poor day "especially in Asia and Australia"**
- **During the day stocks sunk in the morning and rose strong in last ½ hour**

These don't always occur and some patterns have disappeared as became aware

> **"October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February" - Mark Twain**

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